Summary of Chapter III: *How Has Globalization Affected Inflation?*

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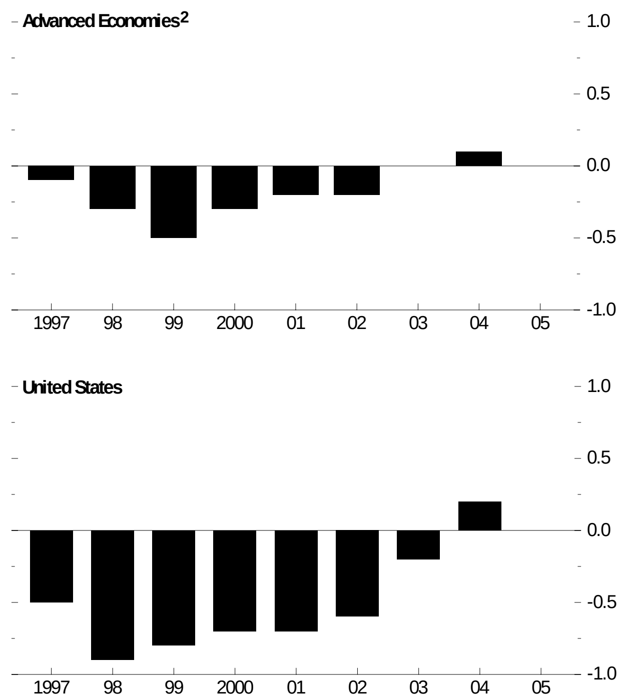
Will more intense global competition prevent firms from raising prices and ensure low inflation in the foreseeable future? This issue is taken up in Chapter III of the *World Economic Outlook*, which explores the link between globalization and inflation. This relationship has been widely debated given that inflation in advanced and many emerging market economies has remained remarkably subdued over the past two years despite a significant rise in commodity prices, strong growth, and a broadly accommodating monetary policy stance in the major currency areas.

The chapter finds that globalization has at times had an important impact on inflation over the past decade. IMF staff estimates suggest that through non-oil import prices, globalization has reduced inflation by an average of a ¼ of a percentage point a year in the advanced economies, with a larger effect of ½ of a percentage point a year in the United States (see the first figure). At times when global spare capacity has increased, however, these direct effects have been larger, shaving more than 1 percentage point off actual inflation in some advanced economies over one- to two-year periods. Examples of such episodes are the 1997–98 Asian financial crises, and the 2001–02 global slowdown. With low average inflation, such effects are economically significant. This lends support to the view that inflation targets should not be set too close to zero—otherwise import price declines of this size could result in periods of deflation.

The Contribution of Non-Oil Import Prices to Inflation[1]
(Annual percent change)



Sources: Eurostat; Haver Analytics; national authorities; and IMF staff calculations.
[1]To capture the impact of globalization on inflation, this scenario removes the impact of oil prices from real import prices. Real import price changes are decomposed into the contribution of oil prices and non-oil commodities. The scenario then assumes that the contribution of oil prices to import price changes was the same as the actual values during 1997–2005 but the contribution of non-oil commodities was at the historical average rate of about 1.6 percent a year.
[2]The group of advanced economies includes Australia, Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

The chapter argues, however, that globalization is no guarantee of low inflation over the next year or two. The main reason is that robust global growth and diminishing economic slack have reduced the restraining impact of declining import prices on inflation. Indeed, with strong global growth expected to continue, the primary risk is that a further upturn in import prices could result in stronger inflationary pressures going forward, and that this will require more monetary tightening than currently expected by financial markets.

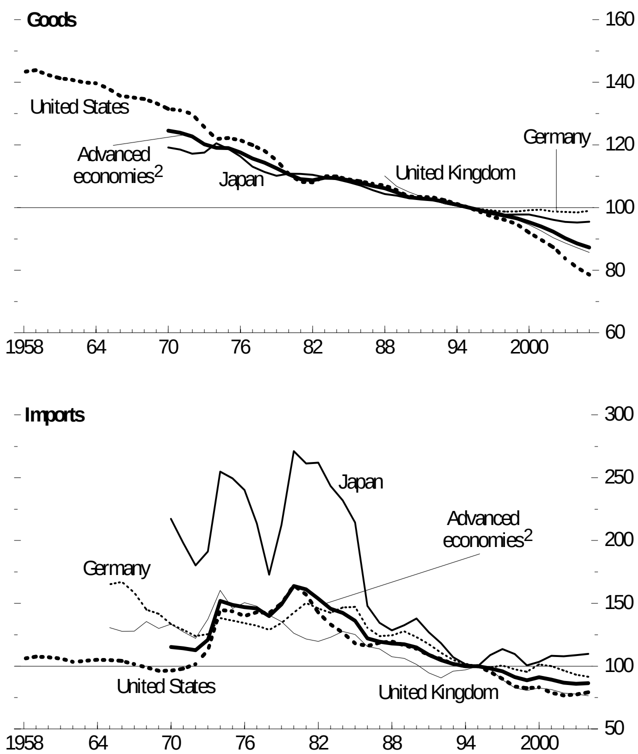
Other main findings of the chapter are:

- **For globalization to have a substantial lasting impact on inflation, it must change the overarching objectives of monetary policy**—such as the central bank's inflation target—which, over the medium term, determines inflation. Globalization-related changes in policy objectives have not recently been observed in industrial countries given already low single-digit inflation targets (explicit or implicit). In emerging market and developing countries, however, greater openness appears to have been one important factor behind the sustained improvement in inflation in recent years.

- **Globalization has contributed to reducing the sensitivity of inflation to domestic capacity constraints**. This is because prices of many items that are produced or consumed at home are increasingly determined by foreign demand and supply factors. Since global economic conditions, especially global capacity constraints, have become increasingly important for domestic inflation, they will require closer monitoring by monetary policymakers in the years ahead.

- **Globalization has restrained price and wage growth in the sectors that have been more exposed to international competition, including, for example, textiles and electronics**. In such sectors, producer prices and unit labor costs have declined relative to the overall price and unit labor cost levels—that is, their relative prices or costs have fallen. This has been reflected in the falling relative prices of goods and imports (see second chart). IMF staff estimates suggest that, on average,

Relative Price of Goods and Imports[1]
(1995=100)



Sources: Eurostat; Haver Analytics; national authorities; and IMF staff calculations.
[1]Ratios of consumer prices of goods and import prices to overall CPI.
[2]The group of advanced economies includes Australia, Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

increased trade openness has reduced relative producer prices in manufacturing by about 0.3 of a percentage point a year over the past 15 years (in a sample of 11 industrial countries). However, when considering relative price and unit labor cost changes, one needs to be mindful that globalization is not the only factor behind recent declines. Productivity growth, which itself is partly related to globalization, has also contributed significantly, particularly in the high-tech manufacturing and services sectors. Indeed, while price increases in the manufacturing sector have consistently been below those in services, the decline in inflation in some services sectors since the mid-1990s has been more pronounced, contributing as much to the decline in overall producer price inflation as the manufacturing sector.